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UNCLAS SECTION 01 OF 03 SHANGHAI 000777

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STATE PASS FEDERAL RESERVE BOARD FOR GOVERNOR
WARSH/AHMED/JOHNSON/SCHINDLER; SAN
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USDOC FOR 4420
USDOC FOR ITA/MAC DAS KASOFF, MELCHER AND MCQUEEN
TREASURY FOR EXEC - TSMITH, OASIA/ISA -DOHNER/BAKER/CUSHMAN
TREASURY FOR WRIGHT AND AMB HOLMER
TREASURY FOR SOBEL AND MOGHTADER
NSC FOR MCCORMICK AND TONG

E.O. 12958: N/A
TAGS: EFIN EINV PGOV CH
SUBJECT: FRB GOVERNOR WARSH TOLD RMB APPRECIATION GRADUAL, NO STOCK
COLLAPSE BEFORE OLYMPICS

REF: A. SHANGHAI 679

¶B. SHANGHAI 251

SHANGHAI 00000777 001.2 OF 003

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¶1. (SBU) Summary: According to the Shanghai branch of the People's Bank of China (PBOC), RMB appreciation will continue at a gradual pace without any dramatic revaluations in the near future. Federal Reserve Governor Kevin Warsh, in Shanghai November 18-20, was also told that the PBOC is closely watching the sub-prime mortgage problems in the United States due to the "close relationship" between the USD and the RMB. Shanghai Stock Exchange senior officials said there is government support for not allowing the stock market to crash before the 2008 Beijing Olympics. Blocking Chinese companies from listing on stock markets overseas is a temporary measure designed to help both the Chinese stock markets and companies in China. The Chinese Financial Futures Exchange's (CFFEX) first product, stock index futures, will not be launched without State Council approval as no Chinese official wants to get blamed should its launch lead to a stock market collapse. Once it is launched, Qualified Foreign Institutional Investors (QFII) will be allowed to allocate 10 percent of their quota to invest in CFFEX products. End Summary.

¶2. (SBU) Federal Reserve System Board of Governors Member Kevin Warsh met with Shanghai-based financial officials including the People's Bank of China (PBOC), the Shanghai Stock Exchange (SSE), and the China Financial Futures Exchange (CFFEX) during his November 18-20 visit to Shanghai. Governor Warsh also met with Bank of Communications (BOCOM) Chairman Jiang Chaoliang, local and foreign financial services businessmen, Citibank CEO Richard Stanley and Standard Chartered Senior Economist Stephen Green during his visit. Embassy Beijing Finatt accompanied Governor Warsh during his meetings in Shanghai. This cable

reports on Governor Warsh's meetings with the Shanghai PBOC, SSE and CFFEX. Other meetings will be reported septels.

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Shanghai PBOC -- We Want to Be Like the NY Fed
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¶3. (SBU) Governor Warsh met with PBOC executive Vice President Hu Pingxi, PBOC Director General Luo Yong, PBOC Deputy Director General Liu Yongfen, and China Foreign Exchange Trading System (CFETS) President Xie Duo on November 20. Hu said that the PBOC established its Shanghai branch in August 2005 hoping that it would play the same role in China that the New York Federal Reserve Bank plays in the United States. Close to China's financial markets, the Shanghai PBOC is assisting in the attempt to turn Shanghai into an international financial center by encouraging financial institutions to move here. It conducts open market operations, monitors and regulates the financial markets, tests "innovative products," and conducts international exchange and communications.

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RMB to Appreciate Gradually, No Abrupt Moves Expected
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¶4. (SBU) PBOC's Hu expressed concern about interest rate decreases in the United States while the PBOC is raising rates in China. The U.S. Dollar is "closely related" to the value of the RMB and so the PBOC is "paying attention" to the possible side-affects in China of fallout from the sub-prime mortgage problems in the United States. Finatt noted the importance of a flexible currency exchange rate regime to a country's ability to set a monetary policy that reflected its own needs. Governor Warsh added that "increasing exchange rate flexibility will help us establish greater equilibrium in otherwise volatile times."

¶5. (SBU) Hu said that the RMB will continue to appreciate gradually without any "abrupt" moves. Due to China's size and "complicated economic factors," the PBOC cannot afford to move in a "radical way." Hu expects the exchange rate to decline,

with "small bounces up" after periods of decline in order for Chinese businesses to try to avoid losses due to RMB appreciation.

No Stock Market Collapse Before The Olympics

¶6. (SBU) SSE Executive Vice President James Liu, noting that the SSE Composite Index (SCI) had risen approximately 100 percent in 2007, said that there had been a flood of new investors entering the stock market (Ref A). These new investors have no experience with a market that may decline as fast, or faster, than it has risen. Liu said that the SSE, the China Securities Regulatory Commission (CSRC), and others throughout the government are focusing on educating investors about the risks of investment. (Note: Econoff recently spotted a Chinese "red letter banner" at a securities firm warning investors that "Bull Markets Have Risks." While the markets have been up as much as 130 percent this year, more than half of investors have actually lost money. End note.)

¶7. (SBU) Liu said that if there was a market crash, there might be pressure -- both on and from some parts of the government -- to bail out retail investors. However, Liu said, "I would hope we wouldn't do that. I would advise against it. Consequences need to be learned." Liu added, "Besides, next year we are holding the Olympics, so we won't let the market tumble before that time. The Olympics are definitely a consideration." (Comment: While many interlocutors have speculated that the Chinese Government would not permit the stock market to crash prior to the August 2008 Beijing Olympics since this could lead to massive protests, this is the first time that post has heard an official explicitly state it. End comment.)

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The Benefits of Listing at Home: We Can Take Care of You
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¶8. (SBU) SSE's Liu noted that the Chinese Government had "put a stop" to Chinese companies listing outside of China. This is a temporary measure that "will not last forever." The CSRC is hoping that Chinese companies that might have wanted to list overseas would list in China. Liu approved of this move since he believes that the majority of Chinese companies that listed outside of China were undervalued by foreign investors and have not performed well.

¶9. (SBU) Liu said that Chinese companies that had listed overseas "did not know what they were getting into, were not prepared, and suffered from a lack of understanding of United States corporate culture." Listing first in Shanghai, and then overseas, gives Chinese companies a chance to function in a more forgiving environment. "If they get into trouble here in Shanghai, we can work with them," said Liu.

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Stock Exchange Still Dominated by Retail Investors
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¶10. (SBU) The share of the market controlled by institutional investors, such as pension funds, insurance companies, and broker-dealer trading, has risen from roughly 10 percent to about 38 percent this year -- a healthy trend, said SSE's Liu. However, more than 90 percent of trading is done by individual retail investors. On high volume days, trading by institutional investors only accounts for 2-3 percent of volume. This means the market is controlled by retail investors and institutional investors "have no voice in setting the market." This even applies to trading done by non-Chinese Qualified Foreign Institutional Investors (QFII) who "throw away everything they know about the market and all of their research to follow the market's momentum created by retail investors," complained Liu.

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The Timetable to Launch Stock Index Future Still Sensitive

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¶11. (SBU) (SBU) CFFEX CEO Zhu Yucheng said that the timing of the launch of CFFEX's first product, a stock index future, is still very "sensitive." (Ref B) When CFFEX would actually launch the stock index future is a decision that would be made at "the highest levels of government." Zhu said that given the overheating on the two Chinese stock markets, launching the equities future product might be the trigger for increased volatility and uncertainty. "If the futures product does not start successfully, 140 million investors will scold me and criticize the government," he said. (Note: Other contacts have told us that delays have been caused by no official wanting to be responsible for launching a product that might cause a collapse, however temporary, of the markets. The decision to launch the index futures product is in the hands of the State Council who most likely do not understand the concept of futures, and therefore are also reluctant to initiate the new product. End note.) Zhu added that he and his staff are closely studying the how the Chicago Mercantile Exchange had "defended their products before Congress so that maybe we can use their arguments."

The Goal is Stability

¶12. (SBU) Attempting to insure stock market stability and avoid volatility, CFFEX's Zhu said that the as yet unlaunched stock index futures product was intentionally designed with a large contract size so that its main customers would be institutional

investors. CFFEX's goal is to set the price so high that private investors would not speculate. Qualified Foreign Institutional Investors (QFFI) will be allowed to invest up to 10 percent of their quotas, said Zhu.

Other Products in the Future

¶13. (SBU) Noting that fund managers familiar with the planned stock index futures product have complained that its proposed structure is not optimal for allowing them to hedge risk, CFFEX's Zhu said that in response to these concerns CFFEX hopes to launch a broader series of financial derivatives should their current product prove successful. CFFEX plans to launch interest rate, foreign currency, and national bonds futures products as well.

¶14. (U) The delegation did not have an opportunity to clear on this report.
JARRETT